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The Financial System in the Decade Ahead: What Should Banks Do?

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THE FINANCIAL SYSTEM IN THE DECADE AHEAD: What Should Banks Do?

CONFERENCE PROCEEDINGS

Including speeches by
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Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City

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SPEAKER

Bank Activities and Structure in the Coming Decade

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I am pleased to be able to participate in today's discussion of the future of the banking system. In my remarks, I will present my thoughts on the future functions of banks, the delivery of banking services, and the evolution of the structure of the banking system. I would note that these are my personal views; other members of the Board may have other opinions.

Before launching into this discussion, I would emphasize that history reveals a strong tendency to overestimate the pace of change in the financial system. While many, if not all, of the changes we are talking about today will indeed take place, the question is: When will they occur?

I am reminded of former Federal Reserve Governor Mitchell, who, in the mid-1960s, predicted many of the changes in the payment system that are occurring today. He foresaw debit cards, stored value cards, home banking by computer, and electronic transfers. Unfortunately for Governor Mitchell's forecasting record, he was predicting these changes for the 1970s. Some of the developments he predicted haven't yet occurred. For example, stored value tickets, such as those used by the Washington, D.C., and San Francisco subway systems, have not caught on more widely in the U.S. However, according to recent press articles, VISA and others are developing a smart card which could be used for transactions that are normally conducted with cash. Such cards with multi-currency capabilities are beginning to be used in Europe.

A recent *Business Week* article contained forecasts of wonderful changes in the payment system. Once again, the imminent demise of checks was predicted. But, as the president of the largest check printing firm pointed out in a comment letter to *Business Week*, in spite of all these forecasts of new systems, the number of checks written in the United States continues to increase.

To take another example of a forecast gone a bit awry, when the states were considering interstate banking laws, smaller banks visualized Citicorp setting up shop next door. Along with a few other New York City and California banks, this was the bank to watch and fear. Who expanded? It's been the banks from Charlotte, North Carolina; Columbus, Ohio; Providence, Rhode Island; and Minneapolis, Minnesota.

As a final example, one-stop shopping at financial supermarkets was another popular forecast that didn't work out. Remember how Sears Roebuck advertised for us to "buy our stocks where we bought our socks"? Now Sears is back to being a retailer again, and we won't be buying our stocks there anymore. The whole idea of bringing all financial services together at Sears or K-Mart seems to have fallen by the wayside.

Thus, being mindful of the dangers of forecasting more change than can be accommodated in the forecast period, I will limit my talk to commercial banking and its structure and keep the forecast horizon short.

The Role of the Commercial Bank

For a small number of banks, especially the largest banks, I believe life is going to change rapidly and drastically in the next decade. Some of these banks will be expanding on a geographic basis as they form multistate organizations or expand their international business. Many already have section 20 securities subsidiaries and will be active in off-balance-sheet activities, such as derivatives. Other banks will be the technological innovators and will be involved in the production of new financial products and delivery systems.

But, while the pace of change will be very rapid for this small group of large banks, for most banks, I don't think that the nature of commercial banking is going to change greatly in the next decade. Deposit-taking and lending will continue to be the core functions of their business, although improvements in technology and communications will speed data flows and make business more competitive and more efficient. But, those of you who have studied banking over time know that things change slowly in this industry, at least for the vast majority of firms. In part, the slow pace of change is due to restrictive legislation; and, in part, it is due to the slow acceptance of change on the part of bankers and bank customers. Additionally, it takes time to accomplish the diffusion of new technology through an interconnected industry composed of thousands of firms.

Thus, most banks will continue to offer the depository and lending services that they have traditionally provided. For these banks, change will come at the margin. Fee income from the production of both traditional and new services will become more important, and these services will be separately priced and cost accounted to assess their bottom-line impact. More loans will be originated for sale into the secondary markets. Changes will assist in the more efficient use and allocation of capital.

For the longer run, I believe that banks should become the diversified financial service providers that Sears tried to become. Sears had the right idea, but it did not have the bank at the core of the organization. As the banking industry consolidates, it will be able to distribute products through the banks' office networks, as well as through the computer and telephone communications systems that will develop.

Such banks will provide a very wide range of financial services, both for consumers and for businesses. Their services will encompass all of those that Sears and the other financial conglomerates were envisioned to provide—banking, securities, insurance, and real estate. Let me speak a little about each of these.

The banks' securities business is already expanding rapidly. Unrestricted underwriting powers are desirable, but it seems likely that the largest banks will fully utilize these powers. Although there is a role for smaller banks in the local municipal markets and in the securitization of small business debt, I expect that most of these banks will concentrate their efforts on the distribution of investment products. The rapid expansion of mutual fund sales through banks is a great example of the potential of a branch banking system. While more sophisticated investors buy no-load funds via mail and toll-free telephone numbers, most funds are sold on a retail basis by stockbrokers. But, since a majority of the population does not regularly deal with a broker, the banking system has a natural advantage in the distribution of mutual finds. Banks should become a prime vehicle for mutual fund distribution.

The sale of at least some lines of insurance is probably more important to banks than the distribution of mutual funds. An insurance brokerage line offers the bank the opportunity to gain a larger share of its customers' total financial business. Like the sale of mutual funds, this is a distribution activity that involves little risk of loss to the banks and can provide convenience to customers.

As most of you know, banks have long wanted to distribute insurance products. Those bank holding companies that have grandfathered insurance powers have found this to be a very profitable activity. Indeed, it is the most profitable of the non-bank activities permissible to bank holding companies. The Board has long advocated allowing banks to act as insurance agents. But, legislative reviews of the issue have not been supportive, and those opposed to the sale of insurance products by banks have placed significant federal statutory limitations on the banks.

Consistent with the one-stop financial service provider theory, a third logical service line for banks, but one which has received little attention in recent years, is real estate brokerage. Who is in a better position to act as a real estate broker than the local banker? The office network is in place, and financing and insurance could be provided along with the house. The bank could originate the loan and sell it into the secondary market, while retaining the service rights with already established bank customers. Naturally, existing real estate firms feel about the same as the insurance agents about allowing banks into their industry.

These new services could be tied together in a comprehensive package by the banks. When combined with financial planning and tax preparation, they would have consumer appeal, would provide all the financial services needed by the average consumer, and could be offered by nearly all banks.

In providing services for businesses, banks will only be able to compete if they are innovative and efficient. The banks' role in lending to large businesses has decreased as non-bank lenders have gained market share. Thus, it is even more important for the banks to retain the financial business of small and medium-sized firms. Much of this business was developed through local market contacts and high levels of service. These were combined with knowledge of their customers, their customers' business, and their customers' markets. The local bankers knew the business of their local customers. Now, many of the local banks are being acquired by large interstate banks. If these new entrants cannot or do not provide the needed level of services to local business customers, the banking system will lose many of these businesses to the non-bank lenders.

Although I do not subscribe to the view that banking is a declining industry, many seem to hold this position. The declining industry issue is the theme of next month's annual bank structure conference at the Federal Reserve Bank of Chicago. Certainly there will be changes, and competitors will pick up some of the functions of banks. Whatever the changes, it is not axiomatic that banking, as we know it, has to have a certain share of the financial services industry in order to survive. Alternatively, perhaps the perceived decline of the banking industry is a measurement problem, and we should give some thought to new, more appropriate measures of the changing character of financial inter-mediation.

Although opportunities abound, in my own view, banks will do best by concentrating on expanding their consumer franchise while retaining their role in providing financial services to businesses. Naturally, they will encounter entrenched opposition as they attempt to expand into other activities. Most of the new activities that I have suggested are now either partially or totally off limits to banks. While public policy should not reserve a certain portion of the financial industry for the banking system, I do not believe the government should place competitive handicaps on banks.

The Delivery of Banking Services

Turning to the delivery of banking services, I think we can look forward to a gradual evolution of the public's payment habits. Most of the innovations that are being forecast will occur; they just probably won't occur as fast as some expect.

First, checks will eventually play a smaller role in the payments system. I won't go so far as to predict the year in which the number of checks will reach its peak. The big move away from checks will come when more bank customers find new systems easy and convenient to use, and when banks price this service to shift the full cost of processing checks to the check writer. Thus, this transition will be driven by pricing decisions, as well as by technological changes.

Second, the use of the ACH for the direct deposit of payroll checks and other regular payments will expand. However, debits to bank accounts for routine payments will grow more slowly, because many consumers are unwilling to give up any element of control over the outflow of funds from their checking account. Again, the pricing of debit card services, relative to other forms of payment, clearly affects the use of this innovation.

In the business sector, corporations are increasingly using electronic transfers to pay their suppliers, as well as their employees. Clearly, moves in this direction offer opportunities to reduce the number of checks written. But, my impression is that there is a long way to go in this area. The same is true for systems to bank at home by computer or telephone. I know that many past innovations in this area have been technologically attractive, but have failed to attract sufficient numbers of customers to be commercially successful. But, the passage of time will replace older people who are not comfortable with computers with younger people who have grown up with the technology. These demographic changes, the spread of computers into more and more homes, and the decline in costs should lead eventually to a profitable home banking system.

Clearly, we will see a transition from a paper-based to an electronic system for the delivery of banking services. But, this is going to take some time.

The Consolidation of the Banking Industry: How Many Banks?

The clearest trend in the banking industry is the consolidation movement. The number of banking organizations continues to decline. There were 11,000 banking organizations in 1985; at year-end 1993, there were only 8,300. While the absolute amount of change seems large, this represents only about a 3 percent per year decrease in the number of banking organizations. Failures accounted for some of the decline, but most is attributable to mergers and acquisitions. More consolidation is now legally possible because of the continued reduction in the barriers to in-state and interstate expansion.

The consolidation movement is not merely the absorption of small banks by large banks; it is also very obvious at the upper end of the size spectrum. For example, of the 100 largest banking organizations at mid-year 1985, 42 have already been acquired or will soon be acquired, assuming that all currently pending acquisitions are approved.

The effect of the consolidation movement is shown in the data on the share of total banking deposits held by the largest banks. For many years, the 100 largest banks held approximately 50 percent of total domestic banking deposits. Now, that percentage has increased to 64 percent.

The fact that this increase in concentration has occurred so early in the formation of interstate banking organizations is quite impressive. As yet, no firm is even close to establishing a nationwide office network. So far, only six bank holding companies have commercial bank subsidiaries in ten or more states. If a 14 percentage point increase in the national concentration of deposits is associated with achieving the current level of interstate banking, I would expect that the ultimate formation of a few truly nationwide banks will result in a much higher level of national concentration.

Does it make any difference if the top 100 come to hold 90 percent or more of commercial bank deposits? Probably not, as long as there is effective competition in local banking markets. The key is whether households and small businesses have access to a reasonable number of alternative sources of financial services from banks and other financial institutions.

Although there may eventually be a much higher concentration of deposits on the national level, there will probably still be many small banking institutions well into the future. While articles predicting doom for the small banks continue to appear, as they have for decades, there is still no evidence suggesting that small banks cannot continue to compete. Not everyone needs the services of a nationwide banking organization, and many customers prefer to deal with a small local bank where their business will be handled by the president of the organization. Correspondent banking relationships will expand to accommodate small banks' needs for specialized or complex banking services. The small banks, having a local base, will act as a competitive check on the performance of the large firms.

Given the anticipated reduction in the number of organizations, one might question whether the antitrust laws would interfere with this consolidation. In general, I believe that they will not. First, especially during these early years of interstate banking, many mergers involve banks that are not operating in the same geographic markets. In many cases, they aren't even in the same states. For example, the merger of Society Corporation in Cleveland and KeyCorp in Albany formed a bank holding company with banks in 10 states. But, there was no geographic market overlap; Society was in Ohio, Michigan, and Indiana, while Key was in seven other states ranging from Maine to Washington State. As long as there is no local market overlap, antitrust issues do not even arise. Second, the current guidelines for evaluating the competitive impact of bank mergers would not block most mergers. In nearly all major local banking markets, many banks could be acquired before the Justice Department merger guidelines would be violated.

The Consolidation of the Banking Industry: How Many Branches?

While the number of operating banks seems quite certain to decline, there is less certainty about the number of branches. Many of the forecasted changes in payment systems would lead to the conclusion that traditional brick and mortar branches will be less important in the future. The ATM performs many of the routine branch functions, and one bank has recently introduced a system for applying for loans through an ATM.

In addition, the massive branch closing programs that often follow mergers create the impression that the number of branches in the nation is declining. Actually, in spite of these closings, the number of operating branches nationwide has not declined, although the rate of increase is much lower than in earlier years.

Before accepting the idea that brick and mortar branches are obsolete, let me make a few points about the number of branches. First, the transition to interstate branch banking will convert a lot of banks to branches because many bank holding companies with banks in multiple states will convert their subsidiary banks to branches. In addition, there will be hundreds of mergers in the process of developing an interstate banking system; each of the acquired banks will probably become a branch of the acquiring bank. Finally, if interstate branch banking is allowed, bank holding companies may convert the offices of their non-bank subsidiaries into branches of their lead bank.

Even with the bank organizational changes we have experienced in recent years, we may not have reached a national equilibrium between the number of banks and the number of branch offices. In those states that have only recently liberalized their branching laws, there are probably still more banks and fewer branches than there will be in the long run. For example, as of year-end 1993, Illinois still had 958 banks and Texas still had 1,011 banks. There is every reason to expect that, especially in states such as these, the number of branches will continue to increase, while the number of banks declines.

Moreover, if banks are to differentiate themselves from money market mutual funds and other non-bank suppliers of financial services, much of the differentiation will be through the provision of local service offices. In fact, banks' branch networks will be key if banks are to become the major vendors of mutual funds and insurance. Those who forecast that branches will be replaced by ATMs are not thinking beyond the provision of basic banking services. ATMs are not going to sell insurance or mutual funds; it is personal contact with staff in a branch office that leads to those sales. Of course, since people don't buy insurance or mutual funds on a daily basis, there may be some room for the reduction of the number of branch offices. And, if the banks are not able to win legislative approval to provide additional services, the number of branches will be more likely to contract.

Conclusion

To summarize briefly, I have made a conservative forecast of the near-term future of the banking industry. While this forecast does not suggest any really radical changes, I believe the change that is forecasted can be accommodated within a decade. I see a banking industry characterized for the most part by an essentially stable core business of deposit-taking and lending, supplemented by fee income from other sectors of the financial services industry—insurance, securities, and real estate. The delivery systems will become more high tech and gradually move away from reliance on paper-based systems. The banking system will consolidate as a few organizations make continued acquisitions in the process of forming nationwide banks. While the number of banking organizations decreases, the number of branches will grow more slowly than in the past and may even contract.

I will close with the caveat that there may be as yet unknown trends, technological innovations, or legal and regulatory changes that will render these visions of the future obsolete.

I thank you again for inviting me to be with you, and I appreciate your attention.

SPEAKER

Challenges for the Banking Industry in the 1990s

Thomas M. Hoenig
President of the Federal Reserve Bank of Kansas City

Over the last decade, significant changes have occurred in banking and the entire financial system. Banking deregulation, new competitive pressures, and technological innovations in communication and information processing have led many to conclude that banking is no longer the same game with the same rules.

In my remarks tonight, I will take a brief look at the trends and challenges that are emerging for banks in the 1990s as they adapt to their new environment. I will focus mostly on how the banking industry appears to be evolving and what this may mean for future operations. I will then outline some of the implications of these banking developments for financial stability. And finally, regarding the appropriate public policy response to emerging developments, I will attempt to outline certain key considerations and possible options.

Emerging Trends in the Banking Industry

Much of our attention over the last decade has centered on bank and thrift asset quality problems, deficits in the deposit insurance funds, and the creation of a new system of supervision. During this period, however, the banking industry itself has undergone a quite remarkable transformation in how it does business. Deregulation, rapidly increasing flows of financial information, an astounding rise in computer processing power, and the development of new financial theories and instruments have dramatically changed banking.

The transformation in banking, in fact, mirrors the innovations in our financial markets, which involve the breaking up of the bank balance sheet. Many of the traditional assets held by banks, although still important, will play a less significant role in bank portfolios, while a variety of services and relatively new off-balance-sheet activities will begin to dominate industry activities. These changes have been most apparent at larger banks. However, in a survey of community banks that our Bank recently conducted, we found many small banks also had made or were planning a number of notable changes in their operations.

While we could debate whether banks are gaining or losing market share, I think a more interesting question concerns what banks actually will be doing throughout the remainder of the 1990s to compete in the financial markets.

The lending function It has become common to view bank lending as something that can be done more efficiently by the "market" in our new age of almost unlimited information flows. Despite a wealth of information, though, some of the biggest blunders in financial history have been made in recent years. To me, this record indicates that there still is a substantial premium to be placed on lenders who can carefully merge information with good credit judgment. Because of their experience in judging credit risks, banks seem destined to maintain a key role in lending, although not without some changes.

One such change is the fading from the bank balance sheet of many standardized credits and loans to highly rated corporations. Compared to investors directly funding such credits, banks face many additional costs, including deposit insurance premiums, non-earning reserves, capital standards, and the burden of regulation. Consequently, the credits on bank balance sheets during the remainder of the 1990s will primarily represent lending to borrowers with unique characteristics, specialized needs, and limited access to financial markets.

While banks will be more specialized in the type of credits they hold, they nevertheless will expand their role in making credit judgments through other means. Banks will focus more on originating and servicing loans to be sold or to be securitized or pooled for the market, thereby avoiding the costs of holding such credits directly. Examples of this include private placement activity and mortgage, auto, and credit card debt securitization. Banks will perform credit evaluations in granting letters of credit and liquidity backups to support the commercial paper and similar markets. Commercial paper for instance, has become a $550 billion market with banks providing a significant portion of issuers' backup liquidity and credit enhancements.

Overall, this evolving role, when compared to traditional bank credit activities, will mean leaving less bank lending on the balance sheet, while placing more of the credit judgment process and its associated risks on an off-balance-sheet basis. While the emphasis will be different, the point is that banks will still need to be attentive to controlling credit risks.

Managing market risk and other services In addition to a changed credit function, banks also will be taking some new directions. These include, for example, helping customers manage interest rate, exchange rate, and other market risks. Such directions are an outgrowth of path-breaking developments in finance and economics in such areas as asset and option pricing theories. In addition, vast increases in computing power have opened the door for these theories to be used on a much broader and more intricate scale.

In this regard, an enormous variety of derivative instruments have been developed to break up and partition risk factors and thereby help individuals, businesses, and financial institutions better manage their own risk exposures. At year-end 1993, bank off-balance-sheet derivatives amounted to nearly $12 trillion, which was a 62 percent increase from just two years before. While this is the notional amount of derivatives and the dollars at risk are typically much smaller, this notional figure is still 3.2 times as large as total banking assets.

While these instruments and activities can help banks and their customers manage risk positions, an evaluation of all the inherent risks may be extremely complex for both bankers and regulators. In fact, a risk manager for a securities dealer was recently quoted in *Fortune* magazine as saying, "If I woke up one day and, God forbid, I was a regulator, I don't think I'd know what to do. With derivatives there's leverage and sometimes illiquidity, and there's complexity. Three words."

As an example of complexity, the pricing and perceived risks in these instruments are often based on a number of critical assumptions that may not be clear to many participants. These assumptions may reflect underlying market conditions, previous price volatility, and historical patterns for mortgage prepayment rates—factors which may never be repeated in the same manner if the financial environment continues to change. With this complexity, it may be extremely difficult to design simple and accurate bank disclosures, and the potential may exist for rapid and substantial changes in risk exposure.

An example of such problems involved Franklin Savings, a Kansas thrift that had made a name for itself through its complex arbitrage operations, expert staff, and ability to "outsmart" major securities firms on trades. In a dispute over accounting practices, the OTS seized Franklin in 1990. What followed was a series of articles and court cases in which a number of well-known arbitrage experts took turns defending and criticizing Franklin's reporting of hedging gains and losses. In the end the courts deferred to the OTS, but two things caught my attention. One was the lack of agreement over Franklin's financial condition and the other was the potential for losses in an institution that was engaged in seemingly safe hedging and arbitrage operations. Several similar stories have since been repeated in the corporate world and in the funds management business.

Deposit competition On the deposit side, banks will face strong competition in the savings and payments transaction markets from mutual funds, cash management accounts, and other savings and payment instruments. One advantage for banks has been their role in the payments system and their access to clearing and wire transfer facilities. These activities, along with extensive office and ATM networks, have given the banking industry a good link to customers. This advantage, though, will be tested over the remainder of the 1990s as electronic innovations give customers more direct access to all of their accounts and investments. Banks consequently will be under pressure to offer a variety of savings instruments, and their success will clearly depend on whether they can provide competitive returns and meet customer expectations.

Banking consolidation A final challenge facing banks is consolidation. Consolidation in banking will likely create an industry composed of three principal types of organizations: a handful of organizations operating on a nationwide level, a group of strong regional organizations, and a substantial number of community banking organizations serving both rural and metropolitan markets. This consolidation will allow larger organizations to diversify geographically and will give smaller community organizations the opportunity to combine with each other and become more efficient.

However, by bringing the banking industry closer together consolidation also seems likely to concentrate payments transactions, off-balance-sheet positions, and other banking risks. Moreover, just like other aspects of banking in the 1990s, consolidation will entail a number of perils and no assurance of success. I would note that some of the early and most feared companies making financial acquisitions—most notably Citicorp, American Express, and Sears—did not enjoy the success they had anticipated. Also, in a study our Bank conducted we found that interstate acquisitions varied widely in their degree of success. Thus, while consolidation can be expected to continue at a rapid pace, the most successful, as always, will be those where careful judgment is exercised in both the selection and execution of the merger.

Implications for Financial Stability in the 1990s

The changes and trends in our financial system not only pose a challenge for bankers, but carry several important implications for financial stability. Gunnar Breivik, a sports philosopher to Norwegian ski jumpers, was quoted in the *Wall Street Journal* as saying, "Pure risk leads to self-destruction. Pure safety leads to stagnation. In between lies survival and progress." While referring to ski jumping, I think this quote does an excellent job of summarizing the challenge for the banking industry and its supervision in the 1990s.

Banking competition, consolidation, and the rising levels of off-balance-sheet activities, if not handled properly, could lead to one of two extremes—a substantial leveraging up of the risks in the banking system or a heavily regulated and stagnant financial system. For survival and progress, banks will have to be both bold and careful while our supervisory system will have to find a balance between risk and safety. This is no easy task, but now is certainly the time to begin looking for this balance.

Changing the supervisory framework Many of the ongoing developments in banking will undoubtedly complicate the task of supervision. For example, how will bank supervisors oversee the wide variety, complexity, and constantly changing nature of off-balance-sheet activities? What about the new forms of credit and market risk banks will face as they operate in an ever more competitive environment, and will public confidence be more of a concern as people struggle to understand pathbreaking developments? Furthermore, what role should the market play through stockholder, creditor, and depositor discipline relative to that of the supervisory authorities?

In past years, we have relied on traditional supervisory techniques, deposit insurance, the discount window, and other elements of the federal safety net to protect the payments system and provide for financial stability. This system, though, has not been without cost, and, indeed, the 1991 banking legislation sought to change some elements of the safety net.

In the 1990s, we cannot afford these costs. We will have to become more adaptive and better able to evaluate in advance of crisis the risks of significant bank activities. One path to this end will be more highly trained and better compensated examiners and supervisors, particularly examiners that can fully evaluate a bank's internal control, hedging operations, and more complex activities. To minimize the regulatory burden on banks, these examiners may further need to have the ability to understand a bank's own operational systems and internal controls and be able to judge their adequacy.

Supervisory and enforcement concerns are already being geared more closely to such factors as a bank's risk control procedures and its management experience and knowledge in offering and monitoring more complex services. In addition, the banking agencies have been making strong efforts to train examiners in evaluating derivative instruments and the internal systems used to track these operations.

Will these steps be enough? In spite of these recent efforts, reasons remain for doubting that the current approach to supervision will be the final answer and for believing that something more is needed to deal with an increasingly volatile financial system. Indeed, several developments in banking will actually complicate any supervisory response to a crisis. Problems include the rising complexity in banking, the potential for rapid shifts in bank funding and risk exposure, and the matter of disclosing adequate information to stockholders, creditors, and depositors.

One answer may be to find a better, less costly way to protect the payments system, which historically has been an essential link in keeping financial problems from becoming systemic. We might, for example, bring back an old concept and place into insulated affiliates certain banking activities that involve substantial risks and are difficult to supervise. Alternatively, we might allow banks to expand services while protecting transaction accounts with a narrow banking format. In both instances, knowledgeable investors and managers would have the responsibility for funding and withstanding the operating risks of activities outside the narrow bank.

Although this separation would not eliminate the risk of such activities, it would assure more stability to the payments system and would allow market discipline to play a more direct role in controlling other specific areas. In addition, it would be consistent with recent shifts toward mutual fund products and might actually bring banks closer to the base of short-term business credit and government securities that once supported their deposits.

Structural steps needed to add more built-in stability A related topic which will influence the stability of our financial system involves structural reforms within our economy. Good judgment by bankers and appropriate regulatory reform, in fact, will go only part way in answering the challenges faced by banks and our entire financial system. As the financial system becomes more efficient and innovative, market participants are becoming more adept at exploiting not only the opportunities within the general economy, but also the distortions.

A clear sign that certain perverse incentives exist is the fact that our financial system was at the forefront of every recent economic crisis, whether it was the credit boom and crunch or energy, agricultural, real estate, commercial, or LDC lending. In addition, the U.S. non-financial corporate sector took $640 billion in equity off its balance sheet between 1984 and 1990, thus channeling much of the credit growth of the 1980s into leveraging up our economy rather than into investment channels and asset accumulation.

Certainly a variety of factors played a role in this binge of leverage and there is no simple way to curtail what one financial columnist has called the "time-honored rhythm, [in which] financial success breeds excess." A starting point, though, might be to place debt and equity financing under more equal tax treatment. Our corporate tax system has created strong incentives for selecting debt over equity, and many recent financial innovations have accelerated this process.

While there are obvious problems in substantially changing our tax structure, failure to take such steps may leave us with a more fragile economy and a business sector without the equity base to focus on long-term investment and research. A number of other steps could also be taken, such as giving banking organizations broader authority to help with the equity needs of their customers. All of these steps could make it easier for both banks and their customers to maintain higher capital levels.

The role for central banks A final matter to consider is how recent developments in banking and financial markets may have broader implications for monetary policy and the international financial system. Our Bank's 1993 symposium, which included financial and monetary experts from around the world, addressed the topic of "Changing Capital Markets: Implications for Monetary Policy." A consensus view emerged from this symposium that financial markets were becoming more fragile at the same time that monetary policy was becoming more difficult to implement.

These changes thus present new challenges for the Federal Reserve and other central banks throughout the world. The developing structure of our financial markets and the emergence of new financial instruments are opening the door for large and sudden shifts in funds within the United States and on an international basis. The 1987 stock market decline and some of the recent turmoil in our financial markets provide examples of the type of market volatility that is becoming possible. Moreover, as these changes are occurring, the relationship between the traditional monetary aggregates and the general economy is becoming more tenuous.

In this new environment, I believe one key factor to achieving more market stability will be central banks' success in establishing a framework for long-term price stability. The expectation of stable prices in the United States and in other countries is necessary to direct spending and investment into appropriate channels, while dampening a major impetus toward speculation in financial and other markets. Beyond this, another essential factor will be the ability of the Federal Reserve and other regulatory agencies to quickly restore stability to the payments system and the financial markets in the event of any disruptions. With the complexity and speed of today's markets and transactions, this objective will require close insight into the changing nature of our financial system.

Summary

Banks will face in the next decade a variety of challenges and we should not underestimate the possible problems. However, the end of banking is far from near. The information revolution of the 1980s was supposed to allow everyone to bypass banks, but in the end, it reaffirmed a fundamental tenet of banking—the value of sound credit and business judgment.

For banks and other participants to survive and prosper in a more complex marketplace, we will need to take several steps to ensure a stable financial system. These steps include maintaining a trained supervisory staff and perhaps separating banking activities that are consistent with depositor protection from those that should more appropriately be conducted through affiliates or other entities.

An additional step that will have to be pursued at some point is to minimize tax distortions and other aberrations that could make our markets even more fragile. Also, we must be sure that the Federal Reserve and other regulatory authorities have the ability to respond to the threats that may be encountered in this new marketplace. If we can follow these steps, banks and other financial systems will be headed in the direction of survival and progress.

ROUNDTABLE

Issues in Community Development

A synopsis of remarks by
Mark S. Carey (moderator), economist, Board of Governors of the Federal Reserve System
Robert T. Clair, senior economist and policy advisor, Federal Reserve Bank of Dallas
Mark Winston Griffith, president, Central Brooklyn Federal Credit Union
Brian Mathis, senior policy analyst, Department of the Treasury
Dimitri Papadimitriou, executive director, The Jerome Levy Economics Institute
Martin Paul Trimble, executive director, National Association of Community Development Loan Funds

The conventional view that banks take in the funds of the community, safeguard them, and lend them back to the community provides the basis for the observation that financial institutions play a vital role in the economic development of the community, according to Dimitri Papadimitriou, executive director of The Jerome Levy Economics Institute. Yet, evidence suggests that traditional banks are reluctant to make loans to firms that are small, are perceived as risky, and have inexperienced management. "Because of this," said Papadimitriou, "firms are denied access to credit. . . . If an area is denied access to credit, its funds flow out of the area." At the same time competition from non-bank banks has forced banks and thrifts to increase fees and raise minimum account balance requirements. As a result, a segment of the population has been forced out of the traditional banking system.

These structural problems provided the framework for a free-ranging discussion on trends in community development and reinvestment. The participants debated a spectrum of issues relating to the dearth of credit and financial services in low-income areas and two key government initiatives designed to solve the problem: the Community Reinvestment Act (CRA), a law designed to limit discrimination by depositories against communities or groups, and the soon to be enacted legislation on community development banks (CDBs), which is expected to earmark $382 million over five years for development in low-income and distressed communities.

"There is little disagreement that economic progress in the recent decades has bypassed numerous individuals, small businesses, minority-owned businesses, and rural and urban communities," said Brian Mathis, a senior policy analyst at the Department of the Treasury. "A significant factor, though not the only factor, in this economic failure was credit deprivation—the inability of distressed populations and communities to gain broad access to the services of traditional lending institutions." This problem includes inadequate banking services, no loans for small borrowers, lack of technical information by borrowers, and discrimination. Without credit resources, Mathis added, "economic revitalization is impossible."

The act establishing the Community Development Banking and Financial Institutions Fund will provide technical and financial assistance to several kinds of specialized lenders known as community development financial institutions (CDFIs). Insured and uninsured CDFIs are required to match financial assistance from the fund with private sources of revenue on a dollar-for-dollar basis, although certain exceptions may apply. This financial assistance can total up to $5 million for qualifying institutions. To qualify, an applicant must present a comprehensive strategic plan, including a business plan that demonstrates its financial and managerial soundness and its prospects for self-sufficiency, an analysis of the needs of the targeted investment area or financial population, and a strategy for addressing those needs. In addition, the applicant must outline a plan to coordinate the use of CDFI assistance with existing government assistance programs and private sector funds. Finally, the applicant must show that its proposed activities are consistent with existing economic community and housing development plans relevant to the investment area and explain how it will coordinate its activities with community organizations and financial institutions.

The concept of CDBs represents "a much needed commitment to economic and social redevelopment based on entrepreneurial spirit, fiscal responsibility, and private sector funding," said Mathis. "I believe it embodies sound public policy principles and builds on private and voluntary sector success. It rewards performance, integrates social values and sound business practices, and views low-income neighborhoods not only as places of need, but also as places of capacity and potential."

CDB legislation has focused on assisting existing institutions, rather than on creating new ones because many community-based institutions already perform many of the functions envisioned by the legislation's sponsors. The Central Brooklyn Federal Credit Union is a case in point.

The year-old credit union serves as a model of the sort of institution that is being targeted for CDB assistance in that it was established "to address problems in the neighborhood that included credit deprivation, lack of financial services, and lack of community control," said Mark Griffith, president of the credit union. The Central Brooklyn Federal Credit Union is a financial cooperative that serves the geographic area of Central Brooklyn and anyone who lives, works, or worships in the neighborhood. With a thousand members and just $2 million in assets, the organization began by offering a range of basic services, including savings and checking accounts and personal loans. The credit union is federally insured. A separate, uninsured fund makes loans to small businesses, loans usually not exceeding $50,000.

The credit union filled a void for affordable credit when many banks fled the neighborhood, according to Mathis. As residents were forced out of the traditional banking system, many turned to what Papadimitriou called "fringe banking"—pawn shops and check cashing operations that charge much higher rates than banks. The interest rate charged by pawn shops can total 240 percent, and check cashing fees, including those for cashing government checks, range from 1 to 15 percent.

It is to supplant the fringe banking apparatus that the credit union is embarking on a new line of services that will compete with check cashing operations in particular. These include utility payments, direct payroll deposits, and electronic payment file transfers, through which the government disburses public assistance checks and foods stamps. The credit union also plans to handle remittances to Caribbean countries, to which many of its members have close ties.

The credit union also plays a role in the community as watchdog, educator, and advocate. It is spearheading financial literacy training and leadership development. "If we're going to change the nature of the financial market in the area, we're going to have to start with young people and get them to understand the relationship between themselves and the economic environment in which they live," said Griffith. "Also we need to train young people so they can take on leadership roles within our organization and others in the neighborhood."

The credit union is also engaged in "research advocacy," conducting surveys of consumer spending patterns and financial services in Central Brooklyn. "We've used [this research] to meet with banks and regulators to try and shape policy on the community reinvestment side of things. . . . We've had an effect on banks in our area." Already, several banks with branches in the area have made deposits in the credit union. Banks are even beginning to "create loan products that are very much like ours."

The CDFI legislation was conceived to help support organizations like the Central Brooklyn Federal Credit Union. But it was the example of organizations like the National Association of Community Development Loan Funds, a federation of 44 nonprofit, community-based financial institutions, that served as a model for the new legislation, according to Martin Trimble, the association's executive director.

The fund raises private capital and reinvests the money in communities like North Camden, N.J., and South Central Los Angeles, which have long been abandoned by private lenders and public agencies. Since the fund's inception in 1985 "we've loaned over $192 million in capital, and our loss rate is less than 1 percent," said Trimble. "In places like North Camden we've been the only lender there in the past fifteen years. North Camden is so disinvested that the only public investment there in recent years has been a suburban highway connector and a maximum security prison." Public officials even closed the local fire station. Not until the Delaware Valley Community Reinvestment Fund, a member fund of Trimble's organization, began lending to the community eight years ago, did private lenders and public agencies commit $350 million over a five-year period to redevelop North Camden.

It is the fund's method of overseeing its affiliates that has served as a blueprint for the CDFI legislation. "We regulate the activities of these nonbank banks who have the clear public purpose of trying to meet the credit needs of working-class and low-income communities across the country," explained Trimble. "We set performance standards for our members, do on-site management audits. We are a lender and an investor in almost everyone of our member funds. And because we have money at risk, money that we've raised from national institutional investors, we lend that money on a performance basis. The loss rate in our member funds is very, very low. . . . Because we have money at risk we're watching our institutions very, very closely."

Trimble criticized the CDFI legislation for not going nearly far enough. "The President missed an important opportunity to raise larger questions about the public purposes the financial system should serve. Unfortunately, what we've got is a pilot program that's going to allocate $382 million, [as] measured against an affordable housing credit gap in New York City alone of $30 billion." What is needed is wholesale financial reform along the lines proposed by Jane D'Arista and Tom Schlesinger, who have argued that our real challenge is to reregulate the financial system, license all financial firms, and hold all financial institutions including nonprofit lenders like credit unions to minimum safety and soundness requirements. Unless the government holds all financial institutions to "some kind of public investment obligation, we are not going to help rebuild the real economy," concluded Trimble.

Robert Clair, senior economist with the Federal Reserve Bank of Dallas, criticized the legislation for supporting what he referred to as the dangers of "undiversified lenders serving a high-risk market. . . . Could a community development bank established for Houston have survived the oil bust when commercial banks lending to investment-grade borrowers went under?"

Mathis countered that if the Central Brooklyn Federal Credit Union "decides to do commercial real estate in downtown Houston, then maybe [it] will have the experience of the thrifts that decided to do commercial real estate in downtown Houston. That's why these institutions and [the] loan funds have enjoyed their success—because they don't try to be all things to all people. They know they have a difficult job to do. And they've developed expertise in doing it."

While the scope and mission of the CDFI legislation is still being debated, the track record of the Community Reinvestment Act, enacted in 1977, has long been especially controversial. The Shadow Financial Regulatory Committee, for instance, has called for repeal of the CRA, charging that "Past experience has shown credit allocation programs to be expensive to administer, difficult to target, virtually impossible to monitor, and ineffective in helping targeted borrowers."

Clair advocated reform of the CRA, rather than wholesale repeal. According to Clair, the legislation differed from previous credit market interventions in one key respect: While all previous credit market interventions were based on the voluntary action of lenders and an incentive structure to encourage their participation, the CRA was mandatory and it had "no positive incentives but only penalties for failure to comply." Clair charged that this "no-carrot-and-all-stick" structure led banks to invest heavily to comply with the CRA, but not necessarily by reinvesting in the low- and moderate-income areas.

Clair called for the government instead of mandating requirements to provide credit enhancements to private sector lenders to make loans to targeted sectors of the economy. Small Business Administration loans and guaranteed student loans are examples. "I'm arguing that if the true goal is community reinvestment, an incentive-based program would be more effective than the current mandated program. . . . If banks realize that it's profitable to make loans in areas they haven't worked in the past decade or so," they might start doing business again in those communities.

Griffith challenged Clair's argument: "I find the terms 'incentive based' and 'voluntary' to be distasteful euphemisms. What we find in communities like mine is that incentives have been there a long time, yet banks have consistently proven that they are not interested in doing the kind of lending we feel is necessary. A study by the Center for Law and Social Justice looked at lending in New York City in two communities with identical income levels and demographics and similar housing stock, but one was black and one was white. There was a marked discrepancy between the loans made in the black community and in the white community. Are those discrepancies the result of market forces? We would be knowingly fooling ourselves to say that if we make the incentives any weaker than they are now that somehow things will improve. It's cynical to suggest that. There are a lot of buzz words used that when you get to the root of them are rather racist." One of them is the term high-risk market.

David Levy, vice chairman of The Jerome Levy Economics Institute, commented from the floor: "The problem is that discrimination isn't just a chosen attitude—a bank saying we'd rather lend to a white community than to a black community. The more serious and difficult part of the problem is when it becomes a product of myth and lack of understanding so that something appears to be too frightening or different, so that people who do not morally think of themselves as discriminating are acting that way. There can be a systemic problem, without having to make an implausible assumption that banks are going to put aside their interest in maximizing profits because they would rather discriminate."

Another problem, said Griffith, is that "there's not a whole lot of profit to be made on small loans, which require as much paperwork as bigger ones.

Clair countered that if the transaction costs are a bigger obstacle than the risk factors associated with making loans, then perhaps "the fees for closing a loan should be subsidized."

ROUNDTABLE

Setting a Policy Agenda for Financial and Banking Reform

A synopsis of remarks by
Paul M. Horvitz (moderator), Elkins Chair in Banking and Finance, University of Houston
Jane D'Arista, lecturer in law, Boston University
James Chessen, chief economist and director of policy research, American Bankers Association
William Janeway, managing director, E. M. Warburg, Pincus & Co., Inc.
Howard A. Menell, Republican staff director, Committee on Banking, Housing and Urban Affairs, U.S. Senate
Hyman P. Minsky, Distinguished Scholar, The Jerome Levy Economics Institute
Ellen S. Seidman, special assistant to the president for economic policy

"In 1994 the banking system was much broader than institutions chartered as banks and regulated as banks," said Hyman Minsky, Distinguished Scholar at The Jerome Levy Economics Institute. "A peculiarly complex structure is evolving under holding companies, in which we have a Mellon Bank buying Dreyfus, for example. Mellon is supervised by the Federal Reserve. Some of its banks may be supervised by the states. Then there is the mutual fund sales organization that is supervised by the SEC, which is not even part of the banking system at all."

Minsky's opening remarks provided an outline for a roundtable aimed at setting a policy agenda for financial and banking reform while seeking the answers to a number of questions, including: Have the problems of deposit insurance been solved? If there is to be some regulation of banking, how should it be structured? What are the implications of the changing system for the financial establishment?

The participants delineated a system that, at least in the near term, could be described in Minsky's words as one that is "groping its way out of the compartmentalized structure of the 1930s, which was designed to keep some parts protected. . . in such a way that the authorities knew what was going on. Now we're escaping from that compartmentalization, but we're also escaping from what the authorities can really understand."

Part of the danger, according to several speakers, including Minsky, is that banks are using their capital to trade. And trading, especially in off-balance-sheet activities such as derivatives, opens a Pandora's box of risk and uncertainty.

Jane D'Arista, a lecturer in law at Boston University, and William Janeway, managing director of E. M. Warburg, Pincus & Co., Inc., spoke, in turn, on the problem of the inappropriateness of the regulatory framework to the changed financial markets.

Sweeping changes in the financial markets, including the proliferation of finance companies, mutual funds, and derivative products, have lead "to a parallel banking system . . . that in no way resembles the legal and regulatory framework that purportedly governs the system," said D'Arista. "Whether we believe in more or less regulation, we have to agree that the problem here is that we're looking at legs and tails and trunks of elephants, but we don't see any elephants. We're tinkering with bad laws, laws that no longer make sense. The system is increasingly unfair and inappropriate and leads to decisions based on regulatory arbitrage rather than economics."

To address this problem, D'Arista laid out a series of prescriptions for leveling the financial playing field.

Impose licensing requirements by which all institutions involved in the same activity would be subject to the same rules. "Any entity that directly accepts funds from the public for investment, makes loans to the public, or buys loans and securities using funds other than its own equity capital and retained earnings or sells loans or third party securities to financial institutions or investors has to be federally licensed . . . That would include hedge funds, because they do more than use their own equity capital." The objective would be uniform price and regulatory costs across the system. Thus, for example, uniform loan loss reserves would be required of all members of the financial services industry so that insurance companies, which today have lower loan loss reserve requirements than do banks, would no longer enjoy a cost advantage over other types of institutions.

Take deposit insurance away from institutions and put it on individuals and transaction accounts. Individuals should receive deposit insurance whether they invest their funds in bank savings accounts, which currently are insured by the government, or in mutual funds, which currently are not insured. Transaction accounts should be given 100 percent coverage because "that's where the domino effect is likely to occur" in the case of a bank failure. As the small saver has moved away from insured funds, the original purpose of deposit insurance has been lost. "Why we continue to insure banking institutions is quite irrational," D'Arista added.

Abandon the too-big-to-fail doctrine. Since nontradable, off-balance-sheet activities—derivatives in particular—have become the principal activity of at least seven major banks in the United States, there is no justification for exposing "such a large share of bank capital now covered by deposit insurance funds" to this type of activity. For these seven major banks the replacement cost (what it costs a bank if a counterparty in a derivatives transaction fails) comes to $250 billion, or two-thirds of the capital of the entire U.S. banking system. The replacement cost for each of these seven banks ranges from over 100 percent of individual capital to over 500 percent.

Require that derivatives be traded publicly. It has been suggested that one solution to the difficulty of valuing derivatives and to the risk inherent in that problem might be to require that all synthetic securities be traded on the exchanges. Another solution might be to force the OTC market to be traded publicly on computer networks, which would probably require the securitization of derivatives.

Picking up where D'Arista left off, William Janeway, managing director of E. M. Warburg, Pincus & Co., Inc., discussed the impact of derivatives on interest rates and the financial markets and the implications of the recent collapse of Askin Capital, a hedge fund. "The creation of the derivatives market has been celebrated as a move toward market completeness and market efficiency," noted Janeway. "There is no such thing whatsoever [because] the creation of a synthetic security in no way entails the creation of a market in which it trades." These securities are created and valued by computer simulations that are run against his torical data in order to attempt t define the modes of behavior of these creations, which have no issuer. Those modes of behavior are then driven by the price performance—in real markets, of real securities—and the computer attempts to keep track of what the value is, or rather what the value *ought* to be if there were an active trading market.

The most significant aspect of the Askin failure was that it didn't happen sooner. "On February 28, 1994, Askin reported the value of the portfolio of his fund, based upon what the computer program said the value of that fund *ought* to be, given the benchmark of pricing of mortgage-backed securities in actively traded markets. At same time actual spreads were widening, and the bids were dropping in those markets. The fact was there was no counterparty for those synthetic securities." Thus, when those who had taken positions in these derivatives—Askin and others—needed liquidity and found no market for those derivative securities, they had to go to a market where there was liquidity, namely, the market for U.S. Treasuries. Thus, the drop in bond prices, related to a recent 50-basis point increase in interest rates, can be attributed to the panic in the derivatives market.

"Computer power to drive simulations is literally limitless and growing exponentially," concluded Janeway. One possible solution to the problems arising from this technological change, he suggested, might be to place margin requirements on synthetic securities.

James Chessen, chief economist and director of policy research at the American Bankers Association, underscored the change in household investment patterns. According to Chessen, 34 percent of all household assets were placed in bank deposits in 1972, but that number had plunged to 20 percent by 1992. Pension funds, mutual funds, and insurance represented only 23 percent of the household balance sheet 20 years ago, but they represent nearly 44 percent today.

One solution to the problem posed by the risks of derivatives and other changes in the financial industry, according to several speakers, might be to create a financial services holding company structure in which some of the subsidiaries of financial institutions would be federally insured and others would not. "The first priority is we don't want to put restrictions on the banks' activities such that they can't be involved with mutual funds or insurance or pension products." said Chessen. "Then, we would be condemning the industry to a tiny box with declining market share. The point is that customers want financial products, they're willing to pay for them, and they want them delivered in a cost effective and efficient manner. We need something like a financial services holding company, providing a wide range of services. And we need a regulatory structure that goes with this kind of format."

Most participants agreed that, at least in the near term, there was unlikely to be any sweeping regulatory reform. Part of the problem in building a consensus for reform, said Ellen Seidman, special assistant to the president for economic policy, is that "there is no crisis." The administration is sympathetic to the notion that "banks can't survive if they are put back into box of doing just deposits and loans." However, Seidman pointed out, two sets of hearings on Capitol Hill, one on hedge funds and the other on functional regulation, indicate how much more complicated the debate over the financial system and regulatory reform has become. "The seemingly simple equation that bank regulators do banks and securities regulators do securities might have been OK in 1983, but it ignores the fact that both types of entities provide the same types of services to the same customers. It's the integrated activities of the whole firm that raise issues of financial stability. This is particularly obvious if we look at the securities firms that have been pushing their derivatives into unregulated subsidiaries over the last several years. Unless we understand how the whole firm works and where the risk lies and ensure that emergency issues and problems are dealt with on an integrated basis, we're simply going to trade one outmoded system for another."

The debate over functional regulation also skews issues relating to unregulated and state regulated entities, according to Seidman. For example, finance companies are subject to many of the same laws that govern regulated financial institutions. Yet, there's a legitimate question as to "whether laws on, say, consumer protection and discrimination are applied as uniformly to entities within a regulated system as to those in an unregulated one. In one case enforcement is done in an affirmative way; in the other its done by exception. There's probably a considerable difference in terms of the results we get. There's a question of whether unregulated entities pose a risk to the financial system, either directly or through their relationships with regulated entities. All of these difficult questions will lead us beyond the debate about traditional functional regulations to a much broader debate about how integrated financial service companies ought to be regulated."

However, both Seidman and Howard Menell, Republican staff director for the Senate Committee on Banking, Housing and Urban Affairs, don't believe that there is much likelihood that Congress will produce any "meaningful, comprehensive financial reform regulation" in the near future. "Politically it's extraordinarily difficult," said Seidman.

The problem, said Menell, is that during the 1980s there was a vigorous debate about bank powers, the financial system, and the regulation of financial services. Bills were introduced in the House and Senate. There was a consensus emerging in 1991 regarding comprehensive reform and financial services holding company legislation. "However, the climate in Congress for acceptance of meaningful reform was negative. Not only was there significant political opposition, but there was also a stock market crash, a real estate crash, and savings and loan failures. There were concerns over the solvency of banks. Congress needed to fund the RTC. These problems made many in Congress rather cautious. The emphasis went from competition, innovation, adaptation to new technology, and diversification to an emphasis on caution, safety, and soundness. FDICIA and FIRREA were concerned with the micromanagement of financial institutions. Congress became risk averse. The debate stopped there."

Congress stands ready to consider meaningful reform, but first the administration will have to develop a policy on financial reform, according to Menell, and "this is not an issue the president will take on in his first term."

Some critics worry that if Congress introduces legislation to regulate derivatives, for example, "we might as well call it the community reinvestment act of Hong Kong" said one conference participant. "It only means that [the business] will be done somewhere else."

Seidmen countered, "It's really important when we are discussing the capital flight overseas argument that we understand the value of our system so that we don't inadvertently screw it up. We have honest financial markets; they're regarded as honest markets. We have accounting that has its flaws, but is a lot better than in a lot of other countries. Our markets are more transparent than those of other countries. There's a desire to use our markets, especially in times of crisis. We can push that too far, but it's important not to inadvertently make the system less reliable."

CONFERENCE SCHEDULE

THURSDAY, APRIL 14

SESSION I
Bank vs. Non-Bank Competition
Philip F. Bartholomew (chair), Director, Bank Research Division, Office of the Comptroller of the Currency

Presentations
George E. French, Associate Director, Research and Statistics Division, Federal Deposit Insurance Corporation
Banking in Transition

Donald G. Simonson, New Mexico Bankers Chair in Finance and Banking, Anderson School of Management, University of New Mexico
Business Strategies: Bank Commercial Lenders vs. Finance Company Lenders

Discussants
James R. Barth, Lowder Eminent Scholar of Finance, Auburn University

George G. Pennacchi, Associate Professor of Finance, University of Illinois

SESSION II
Banking Industry Consolidation
Diana Hancock (chair), Economist, Board of Governors of the Federal Reserve System

Presentations
Daniel E. Nolle, Financial Economist, Office of the Comptroller of the Currency
Banking Industry Consolidation: Past Changes and Implications for the Future

Gary Whalen, Deputy Director, Bank Research Division, Office of the Comptroller of the Currency, and **Robert DeYoung,** Financial Economist, Bank Research Division, Office of the Comptroller of the Currency
Bank Consolidation and Efficiency

Discussants
Douglas D. Evanoff, Senior Financial Economist and Research Officer, Federal Reserve Bank of Chicago

R. Alton Gilbert, Assistant Vice President, Federal Reserve Bank of St. Louis

PRE-DINNER SPEAKER
William A. Schreyer, Chairman Emeritus, Merrill Lynch & Co., Inc.
Saving the American Dream: The Role of the Financial Services Industry in the 1990s and Beyond

FRIDAY, APRIL 15

SESSION III
Issues in Small Firm Finance
Frederick S. Carns, Jr. (chair), Chief, Financial Markets Section, Federal Deposit Insurance Corporation

Presentations
Allen N. Berger, Senior Economist, Board of Governors of the Federal Reserve System, and **Gregory F. Udell,** Associate Professor of Finance, New York University
Lines of Credit and Relationship Lending in Small Firm Finance

Dimitri B. Papadimitriou, Executive Director, The Jerome Levy Economics Institute, **Ronnie J. Phillips,** Research Associate of The Jerome Levy Economics Institute and Colorado State University, and **L. Randall Wray,** Research Associate of The Jerome Levy Economics Institute and the University of Denver
Factoring Companies and Small Business

Raghuram G. Rajan, Assistant Professor of Finance, University of Chicago
Relationships in Small Business Finance

Discussants
Lawrence Cordell, Senior Economist, Federal Home Loan and Mortgage Company

Constance R. Dunham, Senior Economist, Council of Economic Advisers

Arthur J. Murton, Deputy Director, Research and Statistics Division, Federal Deposit Insurance Corporation

PRE-LUNCHEON SPEAKER
The Honorable Susan M. Phillips, Governor, Board of Governors of the Federal Reserve System
The Changing Banking Structure

ROUND TABLE I
Issues in Community Development Banking

Mark S. Carey (moderator), Economist, Board of Governors of the Federal Reserve System

Brian Mathis, Senior Policy Analyst, Department of the Treasury

Robert T. Clair, Senior Economist and Policy Advisor, Federal Reserve Bank of Dallas

Mark Winston Griffith, President, Central Brooklyn Federal Credit Union

Dimitri B. Papadimitriou, Executive Director, The Jerome Levy Economics Institute

Martin Paul Trimble, Executive Director, National Association of Community Development Loan Funds

ROUND TABLE II
Technological Advancement, Institutional Change, and the Evolution of Financial Markets

Robert Z. Aliber (moderator), Professor of International Economics and Finance, University of Chicago

Jane D'Arista, Lecturer on Law, Boston University

William Janeway, Managing Director, E. M. Warburg, Pincus & Co., Inc.

Jan Kregel, Professor of Political Economy, University of Bologna

Patrick Lawler, Chief Economist, Committee on Banking, Housing and Urban Affairs, U.S. Senate

J. Mark Leggett, Senior Vice President and Director of Government Relations, NationsBank Corporation

Dinner Speaker
Thomas M. Hoenig, President, Federal Reserve Bank of Kansas City
Challenges for the Banking Industry in the 1990s

SATURDAY, APRIL 16

SPEAKER
The Honorable Maurice Hinchey, U.S. House of Representatives
Investing in the Community

ROUND TABLE III
Setting the Policy Agenda

Paul M. Horvitz (moderator), Elkins Chair in Banking and Finance, University of Houston

James Chessen, Chief Economist and Director of Policy Research, American Bankers Association

Howard A. Menell, Republican Staff Director, Committee on Banking, Housing and Urban Affairs, U.S. Senate

Hyman P. Minsky, Distinguished Scholar, The Jerome Levy Economics Institute

Ellen S. Seidman, Special Assistant to the President for Economic Policy

LUNCHEON SPEAKER
The Honorable Richard S. Carnell, Assistant Secretary for Financial Institutions, Department of the Treasury

The Jerome Levy Economics Institute of Bard College
Annandale-on-Hudson, New York 12504-5000